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Review of the UNCDF operational reserve

Summary

Recalling decision 79/21 of the Governing Council (now the Executive Board) directing the Fund to establish and maintain an operational reserve of no less than 20 per cent of the its project commitments, this document recommends a new methodology for establishing and maintaining the operational reserve for regular (core) resources and other (non-core) resources to ensure adequate levels of liquidity for UNCDF.

In 2016, as a result of the changing nature of UNCDF operations and in response to a recommendation made by the United Nations Board of Auditors, management instituted a review of the methodology of establishing and maintaining the operational reserve. The current methodology covers the operational reserve for regular resources and is not applicable to other resources. Although UNCDF activities and its funding mix have changed substantially since 1979, the formula for calculating the operational reserve has not been updated. In particular, the current methodology does not adequately recognize changes in the UNCDF programming modalities, its risk management framework, or the transformations that have occurred in its operational and funding capacities.

The document presents a review of the methodology established through decision 79/21 that has been applied since 1979.

The present document includes the recommendations of UNCDF management as to the appropriate methodology for calculating an adequate operational reserve for regular and other resources.

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Based on its review of alternative methodologies, UNCDF recommends adoption of the formula to calculate the operational reserves, for regular resources and other resources, set out in chapter III, 'Recommended methodology for calculating UNCDF operational reserve levels for regular resources', and in chapter IV, 'Recommended methodology for calculating UNCDF operational reserve levels for other resources', of the present report.

Elements of a decision

The Executive Board may wish to: (a) recall decision 79/21 of the Governing Council of UNCDF (now the Executive Board), which approved the current methodology for determining the operational reserve; (b) take note of the present management review of the UNCDF operational reserve, based on the independent analysis undertaken to assess alternative methodologies for calculating the UNCDF operational reserve, for regular and other resources; (c) approve the formula recommended by UNCDF management for calculating the level of the operational reserve for regular and other resources; and (d) request inclusion of the results arising from the revised methodology in the UNCDF integrated budget commencing in 2018.

Contents

Chapter		*Page*
I.	Introduction	3
II.	History of the operational reserve and changes to UNCDF programme modalities and accounting framework	3
III.	Recommended methodology for calculating UNCDF operational reserve levels for regular resources	5
IV.	Recommended methodology for calculating UNCDF operational reserve levels for other resources	5

I. Introduction

1. The present report responds to the audit recommendation made by the United Nations Board of Auditors in 2014 requesting that UNCDF revise its method of calculating reserves to mitigate the expenditure-related, structural, and liability risks associated with cost sharing and trust funds. To address that request, UNCDF initiated its operational reserve review in 2016.

2. This document presents the results of the review of the current methodology for calculating the UNCDF operational reserve, noting that this methodology, established by the Governing Council (now the Executive Board) in its decision 79/21, applies to regular resources only.

3. After providing a brief summary of the history of the UNCDF operational reserve and presenting an analysis of the main changes implemented in UNCDF programme modalities, accounting framework, and operational and funding capacities since 1979, this paper addresses the recommended methodology proposed by independent external consultants for calculating UNCDF operational reserves for regular and other resources.

4. UNCDF adopts the definitions of 'regular resources' and 'other resources' used in the UNDP integrated budget estimates for 2014-2017 (DP/2013/41).

II. History of the operational reserve and changes to UNCDF programme modalities and accounting framework

5. Since its establishment, UNCDF has exercised its mandate[1] to help the least developed countries pursue inclusive growth by following these guidelines:

(a) Leverage and unlock public and private domestic resources for local development;

(b) Promote financial inclusion, which includes digital finance, as a key enabler of poverty reduction and inclusive growth; and

(c) Demonstrate how localizing finance outside the capital cities can accelerate growth in local economies, promote sustainable and climate-resilient infrastructure development, and empower local communities.

6. UNCDF is voluntarily funded, primarily by governments, multilateral institutions, international organizations, foundations and the private sector. Contributions are received in the form of regular (core) resources and other (non-core) resources. For cash and investment purposes, regular and other resource funds are combined; however, each contribution and expenditure is separately recorded and accounted for in the financial records of the project or programme.

7. For regular resources activities, the Governing Council authorized UNCDF to be managed on a partial funding basis, to allow approval of programme activities against anticipated income.

8. As outlined in the UNCDF financial regulations and rules[2], updated in 2012 for the implementation of the International Public Sector Accounting Standards (IPSAS), the

[1] General Assembly resolution 2186, 13 December 1966

[2] UNDP financial regulations and rules, 1 January 2012 (per Executive Board decision 2011/33)

operational reserve is to compensate for and cover the following risks (applicable to core resources only):

(a) Downward fluctuations or shortfalls in resources;

(b) Uneven cash flows;

(c) Increases in actual costs as compared to planning estimates or fluctuations in delivery; and

(d) Other contingencies or liabilities that result in a loss of resources for which UNCDF has made commitments for programming. For examples, risks may include fraud risks; unknown timing of cash contributions pledged by funding partners from year to year; volatility of contribution value in dollar terms due to foreign exchange rate fluctuations; and a decrease in revenues combined with the inability to proportionally reduce administrative expenditures in a timely manner.

9. At present UNCDF has an operational reserve for core resources only. Decision 79/21 directed the Fund to establish and maintain an operational reserve of no less than 20 per cent of its project commitments. Since 1979, UNCDF has applied the methodology to establish and maintain the operational reserve for risk related to regular resources. While UNCDF activities have changed substantially in terms of operational and funding capacities since 1979, the formula and methodology for the operational reserve calculation has not been updated to reflect these changes.

10. For other resources, income-related risks are substantially mitigated by UNCDF financial regulation[3] 5.07(b), which determines that UNCDF must receive contributions before commitments are made and in advance of the implementation of planned activities. However, UNCDF non-core resources are also subject to other kind of risks, such as fraud risk; volatility of contribution value in dollar terms due to foreign exchange rate fluctuations; increases in actual costs as compared to planning estimates or due to fluctuations in delivery; decrease in revenues combined with inability to proportionally reduce administrative expenditures in a timely manner; and other contingencies or liabilities that result in a loss of resources for which UNCDF has made commitments for programming.

11. In the last decade UNCDF experienced a substantial increase in the volume and proportion of other resources contributions over regular resources contributions. While in 2006 other resources accounted for 36.7 per cent of total resources ($8.1 million of other resources over $22.0 million of total resources), the same proportion increased to 78.5 per cent in 2015 ($45.6 million of other resources over $58.0 million of total resources). The growth of other resources activities, which, under the UNCDF financial regulations and rules are required to be fully funded[4], would suggest that UNCDF set aside contingency reserves for risks associated with these activities. However, UNCDF does not have an Executive Board-approved formula for calculating the operational reserve for other resources activities. This paper proposes such a formula.

12. As mandated by the General Assembly resolution 60/283, UNCDF changed its accounting standards from the United Nations Accounting Standards to the International Public Sector Accounting Standards (IPSAS) as of January 1, 2012. As a result, UNCDF transitioned its external and internal financial information from the modified cash basis of accounting used previously to the accrual basis of accounting

[3] UNDP financial regulations and rules, 1 January 2012 (per Executive Board decision 2011/33)
[4] Financial regulation 10.04

(in accordance with IPSAS). Compliance with IPSAS entails a different basis of recording revenue and expenses.

III. Recommended methodology for calculating UNCDF operational reserve levels for regular (core) resources

13. Noting that UNCDF regular resources are authorized to be managed on a partial funding basis to allow approving programme activities against anticipated income, the recommended methodology for calculating the operational reserve for regular resources is based on the following formula: **The operational reserve on regular resources is calculated as 50 per cent (the equivalent of 6 months) of the average of the previous three years' regular resources utilization cash flow-based expenditure for programme and institutional budget.**

14. The application of the recommended approach to 2015 actuals would result in an operational reserve for core resources of $8.6 million. By applying the current UNCDF formula, which requires a fully funded operational reserve of no less than 20 per cent of UNCDF project commitments, the level of the reserve would be $12.4 million.

15. The recommended change in the current methodology to compute the operational reserve for regular resources results in a reserve level determined as a function of the expenditure of the organization rather than of UNCDF project commitments. In line with the external independent risk analysis, UNCDF believes that the recommended methodology would better compensate for the following risks (applicable only to core resources):

(a) Downward fluctuations or shortfalls in resources;

(b) Uneven cash flows;

(c) Increases in actual costs as compared to planning estimates or due to fluctuations in delivery; and

(d) Other contingencies or liabilities that result in a loss of resources for which UNCDF has made commitments for programming.

IV. Recommended methodology for calculating UNCDF operational reserve levels for other (non-core) resources

16. Noting that, under the provision of the UNCDF financial regulations and rules, other resources are required to be fully funded, the recommended methodology for calculating the operational reserve for other resources is based on the following formula: **The operational reserve on other resources equals the total of a reserve for expenditure risks: an average of 3 years' expenses multiplied by 2 per cent, plus a fixed reserve of $0.4 million for contingent liability risks.**

17. The application of the recommended approach to 2012-2014 actuals would result in an operational reserve for other resources of $1.2 million.